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EDITED TRANSCRIPT

BBY.N - Q1 2023 Best Buy Co Inc Earnings Call

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OVERVIEW:

BBY reported 1Q23 enterprise revenues of $10.6b. Expects FY23 enterprise revenues to be $48.3-49.9b and FY23 to be non-GAAP diluted EPS to be $8.40-9.00.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to Best Buy's First Quarter Fiscal '23 Earnings Conference Call. (Operator Instructions) As a reminder, this call is being recorded for playback and will be available by approximately 11 a.m. Eastern time today. (Operator Instructions)

I will now turn the conference call over to Mollie O'Brien, Vice President of Investor Relations. Please go ahead.

Mollie O'Brien - *Best Buy Co., Inc. - VP of IR*

Thank you, and good morning, everyone. Joining me on the call today are Corie Barry, our CEO; and Matt Bilunas, our CFO.

During the call today, we will be discussing both GAAP and non-GAAP financial measures. A reconciliation of these non-GAAP financial measures to the most directly comparable GAAP financial measures and an explanation of why these non-GAAP financial measures are useful can be found in this morning's earnings release, which is available on our website, investors.bestbuy.com.

Some of the statements we will make today are considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These statements may address the financial condition, business initiatives, growth plans, investments and expected performance of the company and are subject to risks and uncertainties that could cause actual results to differ materially from such forward-looking statements. Please refer to the company's current earnings release and our most recent 10-K and subsequent 10-Qs for more information on these risks and uncertainties.

The company undertakes no obligation to update or revise any forward-looking statements to reflect events or circumstances that may arise after the date of this call. I will now turn the call over to Corie.

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Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Good morning, everyone, and thank you for joining us. I am proud of our team's strong execution and focus on providing amazing service for our customers. Throughout the quarter, they navigated the uncertain macro environment and drove higher customer satisfaction scores while keeping energy and excitement going around the initiatives that we believe will drive longer-term opportunities.

We grew our Totaltech membership, increased momentum in our health business, launched new product categories and reached our fastest ever Q1 average online sales delivery speed. At our investor update in March, we said we expected our fiscal '23 financial results to look different. As we all lap stimulus and other government support, our industry cycles the last 2 years of unusually strong demand, and we leverage our position of strength to continue to invest in our future.

In addition, we said we expected promotional activity to increase and supply chain expenses to be a pressure. As such, we guided our annual comparable sales to decline 1% to 4% and our non-GAAP operating income rate to decline 60 basis points to approximately 5.4%. Therefore, the drivers of our Q1 financial results were largely as expected. Macro conditions worsened since we provided our guidance in early March, including higher inflation and the war in Ukraine, which resulted in our sales being slightly lower than our expectations and supply chain costs a little higher than we planned.

Our investment in Totaltech at approximately 100 basis points of gross margin pressure was in line with our expectations and revenue from our credit card profit share was higher than anticipated. Overall, I am proud of our team's ability to develop and execute plans to adapt to the changing environment over the past 2 years and to the more recent macroeconomic conditions. Our revenue and profitability remained much stronger than they were pre-pandemic.

Q1 revenue of $10.6 billion is $1.5 billion or 16% higher than Q1 of pre-pandemic fiscal '20. And while our non-GAAP operating income rate is currently being impacted by our investments, it is still 80 basis points higher than fiscal '20, even with those investments and supply chain pressures. Our Enterprise comparable sales declined 8% as we lapped particularly strong comparable sales last year. The 37% comp sales growth in Q1 of last year was driven by the timing of government stimulus payments, lapping a quarter during which our stores were closed early in the pandemic, and the heightened demand for stay-at-home focused purchases.

From a category standpoint, the biggest contributor to the comp sales decline were computing and home theater. Although down from last year's strong sales compared to Q1 of fiscal '20, our computing revenue has grown more than 30%. Our Domestic Appliance business, which has grown every quarter except for 1 for more than 10 years, delivered comparable sales growth of 3% on top of 67% growth last year.

We aspire to help customers with all their technology needs in the most seamlessly possible across all touch points, and we are encouraged by the improvements in our customer Net Promoter Scores. We have been leveraging our omnichannel strength to serve and support our customers as their shopping behavior and expectations have evolved significantly over the past 2 years. While customers have returned to physical stores to see and touch products and get advice, our digital engagement with customers remains very high. Our online sales as a percentage of domestic sales are 31%, still twice as high as prepandemic levels. And revenue from virtual phone and chat interactions continues to increase rapidly.

Additionally, we are expanding our engagement with customers in their homes as in-home consultations and in-home installations are up significantly. During the quarter, we saw higher NPS overall, and we saw our highest ever NPS from in-store purchases and in-store services. I would like to take a moment to expand on the topic of inflation, important in the current environment. Like other companies, we have seen cost inflation in areas such as labor, marketing and supply chain. However, this cost inflation was largely in line with our expectations and benefited from planning and execution over the previous 2 years.

As it relates to product pricing, we have seen an increase in our average selling prices over the past 2 years due to a number of factors. First, our product sales mix has changed as customers have mixed into premium products at higher price points. This has been happening for years and accelerated during the pandemic. Additionally, we have driven material growth in appliances, which carry high ASPs and have become a larger part of our mix.

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Second, there was overall lower promotional and markdown activity during much of the pandemic due to the shortage of product to meet demand. And third, our vendors are absorbing higher transportation and component costs and some of that has led to higher cost of goods sold for us. In many cases, we have passed through this higher cost of goods sold in the form of higher prices to customers.

Importantly and fundamentally, we aim to be competitive in our pricing. We have seen a pickup in the promotional environment as we have consistently noted, starting in July of last year. As we entered fiscal '23, we expected the promotional environment to create margin pressure in Q1 and throughout the year. In Q1, we did experience a more promotional environment for many of our products when compared to last year. And some products were even more promotional than we expected coming into the quarter and were similar to pre-pandemic levels.

Turning back to our Q1 results. Our ending inventory was up 9% compared to last year and essentially in line with the growth of our revenue since fiscal '20. Our teams did an amazing job actively managing inventory levels as the quarter progressed in this evolving supply and demand environment. Pockets of inventory constraints still exist, but are currently isolated to certain products and vendors.

Overall, our inventory remains healthy. Even though inventory availability in CE is much better than it has been for much of the pandemic, the supply chain continues to be challenging with ongoing transportation disruptions and higher costs including containers, labor and fuel. We are, of course, not immune to the supply chain challenges in the world today, and we are seeing some impacts on our business. We have invested in many aspects of our supply chain over the last several years in ways that have helped us navigate the environment and mitigate the impacts.

We have employed a portfolio approach as it relates to carriers, transportation partners and parcel delivery partners. And we have built deep relationships across our supply chain, including port carriers and deconsolidation operations. In addition, we strategically leveraged the use of both rail and over-the-road transportation modes to move product. All of this has helped us to drive capacity, avoid large-scale disruption and mitigate cost increases.

Importantly, our contractual relationships have allowed us to limit our exposure to the more turbulent spot market. The strong relationships we have cultivated with our vendors have also been crucial to our navigation of the supply chain environment. Working closely with our vendors, we have a great deal of visibility into and can influence the status of product in the supply chain process.

Additionally, we actually handled transportation for many of our vendors, meaning we take control in Asia or Mexico. Then we have full visibility and control of the inventory movement and costs. We have invested in our distribution center network, effectively bringing product closer to customers and implementing technology solutions that increase productivity and speed to customer. We have also invested in our store-based fulfillment, including our ship-from-store customer fulfillment centers, and implemented an effective employee delivery system.

These investments have allowed us to make dramatic improvements in speed of delivery to our customers, even with the significant increase in volume in the past 2-plus years. In addition, we have many options for our customers to pick up their products themselves through in-store pickup, curbside pickup, lockers and alternate pickup locations. Customers clearly appreciate the convenience as the percentage of online sales picked up in stores has remained relatively consistent over the past several years at approximately 40%, even with the incredible improvements in shipping time.

As it relates to ESG, we remain encouraged by the recent recognition of our work to support the environment and our community, both inside and outside Best Buy. We are proud to be included on Ethisphere's 2022 World's Most Ethical Companies list. We are 1 of only 3 retailers on it and it's our eighth time earning the honor. We were also included on the 2022 Forbes List of Best Employers for Diversity as 1 of the top 4 retailers on the list. It's our third consecutive year making the rankings that recognize leadership and commitment towards building a more inclusive workplace.

During the quarter, we expanded our recycling program to include a new service for customers who are looking for our help recycling their large products. For a fee, we will go to customers' homes to pick up large electronics and appliances as well as an unlimited number of small products and ensure they're responsibly recycled and kept out of landfill. This service is in addition to our everyday recycling programs available at all Best Buy stores and our Holloway service with the purchase of new products.

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As I mentioned earlier, our employees executed well in the evolving environment, in many cases making hard decisions to run the business effectively and prioritize our customers. Even with the expected slowdown this year as we lap 2-plus years of pandemic impacts, we continue to be in a fundamentally stronger position than we expected to be at this point. We are confident in the strength of our business and excited about what lies ahead.

We have a compelling value creation opportunity and are investing now, as we have successfully invested ahead of change in our past, to ensure we're ready to meet the needs of our customers and retain our unique position in our industry. As we provided a more detailed investor update in combination with our Q4 results on March 3, I'm not going to outline all our initiatives, but would like to provide a few updates on our progress.

In March, we spoke quite a bit about Totaltech, our unique membership program that includes member pricing discounts, product protection, free delivery and installation and 24/7 tech support. Fundamentally, Totaltech is designed to provide our customers with complete confidence in their technology. Buying it, getting it up and running, enjoying it and fixing it if something goes wrong.

During the quarter, we continued to sign up more members as customers realize the great benefits of the program. And we are encouraged by the higher engagement, customer satisfaction and increased revenue we continue to see from customers who have signed up to become members. We are pleased with the pace at which we are acquiring new members, especially considering the macro environment. We continue to see that Totaltech has broad appeal across customer segments.

Additionally, we are improving our ability to gain members not only in retail stores but in our digital and in-home channel. As a reminder, from a financial perspective, Totaltech is a near-term investment to drive longer-term benefit. We expect year-over-year pressure on our gross profit rate to cease as we lap the launch in October. And over time, we expect the incremental spend we garnered from members will lead to higher operating income dollars. Accordingly, Totaltech is a significant contributor to our fiscal '25 goals.

As we outlined in March, we are optimizing our workforce and reimagining our physical presence in ways that serve our customers' needs in our more digital world. We are making investments that provide a better, more seamless shopping experience as the customer moves from online shopping to visiting our stores to video chatting from their home.

This includes our virtual sales strategy. Early in the pandemic, the volume of customers interacting with us via phone and chat skyrocketed. The volume has remained high, and we are actively working to increase the sales opportunity of these interactions through a number of efforts. One, we are leveraging a team of expert sales associates working from their homes, many of whom have in-depth store experience and are certified in multiple categories. Two, we have staffed our virtual store with dedicated experts who can help you via video and demo a product just like they would in our store. And three, we are enhancing the training for our offshore call center agents to help them feel like confident salespeople.

We are already seeing great results as revenue from these interactions more than doubled in Q1 compared to last year. Enhancements to our technology platforms are in progress to further streamline our operations and enable these employees to chat, video, text, share their screens and transact. With this, we will be able to accelerate the productivity and sales opportunity further.

We have spoken quite a bit about our consultation service that provides customers with expert help and inspiration tailored to their unique tech needs often right in their homes. This is growing and important as we continue to see very high customer satisfaction scores and increasing spend by customers who engage with the consultants. We also have a team that is focused on providing tech products and solutions for businesses in specific industries, including homebuilding, hospitality and health care. We have been growing this aspect of our business for several years and more recent investments in our digital capabilities and fulfillment have led to strong growth momentum that we expect will continue.

For example, Q1 revenue from this team was up 15% over last year's Q1 and up more than 70% from Q1 of fiscal '20. As I step back to comment on our overall workforce, we have been actively evolving the composition of our teams throughout the last 2 years as customer behavior changed and became even more digitally focused. The result is that our overall head count is actually lower than pre-pandemic. We feel like we are largely at the right number as it relates to the strategic evolution of our operating model, the demand we are seeing and the nature of our customer interaction. We will continue to learn, evaluate and evolve the model in light of the way the business and shopping habits are changing.

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At the same time, we have invested and will continue to invest in flexibility, training, compensation and benefits for our associates. We are incredibly proud that our field turnover rates remain significantly below the retail average and are near our prepandemic turnover rates. Additionally, our store general manager turnover is just 6%, meaning our GMs have the tenure and experience to effectively help their teams navigate this dynamic environment. It is clear that we have store managers who are invested in their employees, their career paths, their well-being and their communities, and I thank them for their dedication.

Of course, as previously noted, we are also reimagining our physical stores. This year, we expect to complete approximately 45 remodels to implement our experience store concept. We are excited about these remodels as we continue to see higher revenue and NPS in the pilot locations compared to the controlled stores, especially as one of the pilots has been running almost 2 years. We also continue to see strong results from our outlet stores and are on track to roll out more this year with new stores opening soon in Chicago, Houston and Phoenix.

Our outlet stores assort open box, clearance, end-of-life and otherwise distressed large product inventory in major appliances and televisions that might otherwise be liquidated at significantly lower recovery rate. We tend to see twice the recovery rate of our cost of goods sold when we sell this product at our outlets versus alternative channels. Additionally, these locations can attract new and reengaged customers.

Last year, we estimated that approximately 16% of outlet customers were new to Best Buy and 37% were reengaged Best Buy customers. In fiscal '23, we plan to double the number of outlets by opening 15 additional stores, and we are expanding our assortment beyond major appliances and large TVs to include computing, gaming and mobile phones. We are already seeing increased performance in these new outlet formats as customers gravitate to the expanded assortment.

Finally, these outlet stores are an important element of our circular economy strategy by providing a second opportunity for products to be resold instead of ending up in a landfill. And another important element of this circular economy strategy is our trade-in program. We have an extensive trade-in program covering more major CE categories than anyone else. In Q1, we took in 135,000 trade-in units from customers. Not only does our trade-in program keep tech products out of landfills, our customers typically spend 3x the amount they received on their trade-in on new products at Best Buy.

We are continuing our category expansion strategy as well. For example, we're helping customers commute more sustainably with a new lineup of the best electric bikes, scooters and mopeds. Over the next 18 months, we'll be bringing up selection of these products to nearly every Best Buy store. We're also rolling out charging devices, perfect for our customers' garages in several stores. And Geek Squad cannot only assemble the e-bikes for customers, but we're also beginning a pilot to test service and repair for e-transportation products in some of our stores.

We also just recently announced further expansion into the health and beauty category by launching new skincare technology products online and in 300 of our stores. In our Best Buy Health business, we are pleased with our first quarter momentum. In Q1, we saw strong growth in new sign-ups for our active aging business that offers health and safety solutions to enable adults to live and thrive at home.

In our Emerging virtual care business, we connect patients with their physicians to enable care at home. Last November, we acquired Current Health, a technology company with an FDA-cleared monitoring platform for care at home to help us accelerate our strategy. The combination of Current Health offerings and our scale, presence and Geek Squad in-home capabilities is already resonating with the healthcare industry. Boosted by its affiliation with Best Buy, Current Health had its best commercial booking quarter ever, including expansion of its relationships with health systems such as Mount Sinai Health System, Parkland Health, as well as the U.K. National Health Service and others.

I'm excited to share that Current Health was awarded best hospital technology implementation in the 2022 MedTech Breakthrough Awards program for its role in supporting health systems across the U.S. implement innovative care at home programs. Current Health was also selected by Frost & Sullivan as the 2022 Company of the Year in the global virtual home care platform industry.

In summary, I am proud of how much we accomplished in the first quarter and excited about what lies ahead for us. Clearly, there remains a great deal of uncertainty. On one hand, consumers still have relatively strong balance sheet, they continue to spend, wages are up and unemployment is at record lows. On the other hand, many consumers are lapping stimulus income they received last year and are also facing issues like higher

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gas and food prices, rising interest and mortgage rates, recession fears, stock market volatility and geopolitical uncertainty stemming from the war in Ukraine.

Underlying all that is the gradual shifting of spend from stay-at-home purchases to more experiential spend on services and the activities, many were unable to enjoy during the pandemic. As I mentioned at the start of my comments, while the drivers of our results were largely as expected, the comparable sales decline of 8% was on the softer side as inflationary pressures heightened throughout the quarter. That trend has continued into the beginning of Q2, and it does not appear that it will abate in the near term.

Therefore, as Matt will outline, we are revising our guidance and now expect fiscal '23 comparable sales decline in the range of 3% to 6%. And we are correspondingly updating our non-GAAP operating income rate to a range of 5.2% to 5.4%. We will continue to proactively navigate this rapidly changing environment, balancing the day-to-day operations with our commitment to our long-term strategy and growth initiatives.

Before I turn the call over to Matt for more details on Q1 and our outlook, I want to thank our employees for everything they do for our customers in all our channels. I greatly appreciate your teamwork and perseverance. I love the Best Buy culture and our commitment to enriching lives through technology. And I will close by saying this. We firmly believe that technology is more relevant today than ever. Every aspect of our lives has changed with technology, and we uniquely know how to make it human in our customers' homes right for their lives. From our expertly curated assortment to in-home consultations, all the way to tech support when your tech isn't working the way you want or traded in recycling when you want to upgrade. We believe we have an ability to inspire and support customers in ways no one else can.

And with that, I would like to turn the call over to Matt.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Good morning, everyone. Hopefully, you were able to view our press release this morning with our detailed financial results. As Corie mentioned, we expected our Q1 financial results to be softer on a year-over-year basis. .

Our Enterprise revenue of $10.6 billion declined 8% on a comparable basis as we lapped a very strong 37% comparable sales growth last year. Our non-GAAP operating income rate of 4.6% compared to 6.4% last year. If you compare it to the first quarter of fiscal '20, before the pandemic, our non-GAAP operating income rate increased 80 basis points. Our revenue growth has clearly played a role in our improved SG&A rate, but I would also like to highlight a few other factors. Our investment in Totaltech membership alone added more than 100 basis points of operating income rate pressure this quarter compared to the fiscal '20 period.

We are also investing in Best Buy Health. These are both areas that we know create near-term pressure, but we believe they will drive compelling financial returns over time as they scale. I also want to note that since fiscal '20, our mix of revenue from our online channel has more than doubled, and we have efficiently evolved our operating model to support this shift in consumer shopping behavior, while at the same time, navigating higher wages and increase supply chain and technology costs.

Let me now share more details on the first quarter performance versus last year. In our Domestic segment, revenue decreased to 8.7% from $9.9 billion, driven by a comparable sales decline of 8.5%. From a monthly phasing standpoint, as expected, the largest comparable sales decline was the 5-week fiscal March period. As Corie noted, from a category standpoint, the largest contributors to the comparable sales decline in the quarter were computing and home theater. In addition, services comparable sales declined 12% this quarter. This was primarily the result of our Totaltech membership, which includes benefits that were previously stand-alone revenue-generating services such as warranty and installation.

In our International segment, revenue decreased 5.4% to $753 million. This decrease was driven by the loss of $19 million in revenue from exiting Mexico and a comparable sales decline of 1.4% in Canada. Turning now to gross profit, where our enterprise rate declined 120 basis points, 22.1%. The domestic gross profit rate declined 140 basis points, which was primarily driven by lower services margin rates, including pressure associated with Totaltech. In addition, lower product margin rates, which included increased promotional activity and the impact of higher supply chain costs also negatively impacted our rate during the quarter. The previous items were partially offset by higher profit sharing revenue in the company's private label and co-branded credit card arrangement.

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Lastly, our International non-GAAP gross profit rate improved 130 basis points compared to last year, which provided a weighted benefit of approximately 20 basis points to our Enterprise results. As a reminder, the gross profit rate pressure from Totaltech primarily relates to the incremental customer benefits and the associated costs compared to our previous Totaltech support offer. On a weighted basis, the services category negatively impacted the Domestic gross profit rate by approximately 100 basis points compared to last year, which largely aligned with our expectations entering the quarter.

Moving next to SG&A. Our Enterprise non-GAAP SG&A decreased $100 million while increasing 60 basis points as a percentage of sales. Within the Domestic segment, the primary driver of the reduced SG&A was lower incentive compensation of $130 million, which included lapping $40 million for onetime gratitude and appreciation awards last year. Partially offsetting the lower incentive compensation were increased expenses for advertising and our health initiatives.

During the quarter, we returned a total of $654 million to shareholders through share repurchases of $455 million and dividends of $199 million. Our quarterly dividend of $0.88 was an increase of 26% and marked the eighth straight year of regular dividend increased at least 10% compared to the prior year. Consistent with our original guidance, we expect to spend approximately $1.5 billion in share repurchases this year.

Let me next share more color on our guidance for the full year. Many of the key assumptions driving our outlook from when we enter the year remain unchanged. We still expect the first half of the year to be more pressured on a year-over-year basis for both revenue growth and our non-GAAP operating income rate. In addition, we still expect the non-GAAP operating income rate decline to be primarily come from lower gross profit rate, with Totaltech being the key driver.

Let me next share some context on what has changed in our outlook. Entering the year, we were cognizant of lapping the large levels of government stimulus actions last year. As we already shared, sales came in a little lower than our expectations for the first quarter, and this trend has continued into the second quarter. It is difficult to assess how much of the decline may be longer tail associated with elevated stimulus spending last year or overall consumer spending slowing down due to inflationary concerns and the shift of consumer spending to experiences.

Based on the trends we are seeing over the past several weeks, we now feel it's more likely that we will be on the lower end of our original guidance expectations. As a result, we now expect comparable sales to decline 3% to 6%. As Corie discussed, clearly, there is still a lot of uncertainty in macro cross currents. Thus, we will continue to assess the sales trends, adjusting for our spend for variable items like advertising and store labor, as well as discretionary areas as appropriate. We also expect favorable trends in our private label credit card arrangement to partially offset higher costs in areas like supply chain for the remainder of the year.

At the same time, we remain committed to progressing the initiatives, we are confident will deliver compelling financial returns in the future. As a result of the lower sales outlook, our non-GAAP operating income rate outlook is now 5.2% to 5.4%. Based on these factors, I've just outlined, our guidance for the full year now represents the following: Enterprise revenue of $48.3 billion to $49.9 billion, a comparable sales decline of 3% to 6%, Enterprise non-GAAP operating income rate of approximately 5.2% to 5.4%, non-GAAP diluted EPS of $8.40 to $9.

We expect our non-GAAP effective tax rate to be approximately 24%. And lastly, we still expect capital expenditures to be approximately $1.1 billion.

As we shared on our last earnings call, we no longer plan to provide quarterly guidance going forward. However, we'd like to provide context on our expectations. Several of the key themes from the first quarter are expected to be consistent in the second quarter. As a result, we anticipate that our second quarter comparable sales and the year-over-year decline in our non-GAAP operating income rate will both be very similar to our first quarter results.

Also, as a reminder, last year's second quarter included a onetime diluted earnings per share benefit of $0.47 from a lower effective tax rate. I will now turn the call over to the operator for questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We take our first question today from Zachary Fadem of Wells Fargo.

Unidentified Analyst

It's actually [Sam Reed] pitching for Zach here. I wanted to ask kind of a big picture question. Maybe could you sort of recast your FY '25 assumptions in the context of today's updated guidance? Obviously, some of these macro headwinds you called out are maybe likely to be temporal. That said, does it put more pressure on your business to deliver in FY '24 and FY '25? And how should we be thinking about those 2% to 4% outyear comps in that 6.3% to 6.8% operating margin target in that context?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes. Thank you for the question. Obviously, I think it's way too early for us to be updating our FY '25 goals at this point. You're right. I mean I think the lowering of the range this year does create a bit of a different picture. But at the same time, we very much believe in the strength of our industry and are very encouraged by the initiatives that we have, that we outlined at the Investor Day, Totaltech, and expanded assortment in our health initiatives. Those all remain the same. And if anything, we're even more excited about those as we look forward. So obviously, the ranges we gave this year, they're pretty wide. And the ranges for FY '25 is still pretty wide. So there's a number of outcomes we already had contemplated in setting those goals back in March. So we still remain pretty confident in those numbers.

Unidentified Analyst

Awesome. No, that's super helpful. And then maybe pivoting a little bit here to appliances. Obviously, it's great to see you guys still delivering positive comps here, especially given what you were up against last year. Kind of maybe you want to talk to the sustainability of the positive comps in the appliance segment, especially as we really kind of continue to lap some of that stimulus and maybe face some of these macro pressures.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes. I think this appliances has been a place where we've been sustaining growth for a long time, what's been growing every quarter for 10 years, except for one when we closed our stores. So we are very confident in our team's ability to continue to drive sales up. Clearly, there are some very elevated levels of comp that were coming over the last couple of years of spend. But the team continues to drive the assortment and the experience changes that making it a very meaningful place to buy appliances. And that includes both the majors and the small side. So we remain really excited and confident about the prospects there. For the fifth straight year, we received J.D. Power Award for the highest customer satisfaction among appliance retailers. So the team is getting the right experience that I think will help us drive sales higher as we look into the future.

Operator

We take our next question from Steven Forbes of Guggenheim Partners.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

Corie, I want to put focus on Totaltech, and I appreciate the color, but I was hoping if you can provide us a little more details around how membership is framing relative to expectations, maybe in the context of churn and/or retention? And then just a broader comment on what part of the value proposition do you think is resonating most with your customer in the current sort of environment?

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Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Yes. So I'm just going to start by taking a little bit of a step back here. Obviously, what we're aiming to do here is take our deep knowledge of the customer, combined with our history of a multitude of membership programs and our unique abilities to create a very unique paid membership offer with very broad reach. That broad appeal means we see more different types of demographics that this appeals to. And by the way, it is also more comfortable to sell because our associates just have a lot of passion around the multitude of offers. To specifically your question about what's resonating, the truth is all aspects are resonating, but different pieces seem to resonate with different demographics. Certainly, the included warranty aspects, especially the Apple Care resonates with some of our younger demographics. The pricing and discounts actually resonates across all and then the support we see resonate with some of our older demographics.

So the point here is actually this broad reach of a multitude of pieces of the offer that will actually appeal to many. The purpose, as we said, is to drive frequency and share of wallet over time. The reason we're not updating right now is we are just starting to lap our beta test from last year, if you remember, we actually launched in April with the full rollout in October. And so we are literally just getting a feel now for what retention looks like. It remains in line with -- as we've converted customers remains in line with -- what we had expected. But right now, we're just -- we want to actually start to lap some of those new customers who actually opted into the program before we comment too much on retention.

What I will say is, look, the goal here is to create a moat around the consumer. And to make it kind of inconceivable for them to buy CE anywhere else. And we know we're growing our share of wallet with those that are shopping us. So we know it's doing what we want it to do, but we're using this time period to continue to learn and iterate on the acquisition, the usage that we're seeing right now and then ultimately those retention figures.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

I'll keep it to one. Best of luck. .

Operator

Joe Feldman of Telsey has our next question.

Joseph Isaac Feldman - *Telsey Advisory Group LLC - Senior MD, Assistant Director of Research & Senior Research Analyst*

Back on the promotions, you mentioned some products are starting to get more promotional. And I guess I was just wondering which areas you're seeing more of that pressure and your view of promotions, maybe the balance of this year, will it accelerate or do you think it'll just be kind of normalized relative to a year ago?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure. Thanks, Joe. As we outlined back in March, we expected to see promotions be pressured this year compared to last year. And we also commented that we -- that eventually, they would return to closer to FY '20 levels at some point. As we've got into the quarter, we actually started seeing a little bit more pressure on the promotion side than we expected. Again, that was offset by a little bit of credit -- better credit card profit share from the arrangement we have. But we did see a little bit more promotionality. And I think it's pretty broad across most of our categories. We're starting to increase in terms of the amount of discount and the mix on promotion. TVs was a place where we did see more promotions on a year-over-year basis. Computing has been starting more promotional all the way back to July of last year. So that continued as well.

So those are the areas I'd probably highlight, but there are also even just some very iconic type of products too in specific categories that are very promotional, even though in some cases inventory is constrained. And so overall, we know it's returning as we expected it would. It isn't quite back to FY '20 levels, but it is heading in the same -- heading to that path as we expected.

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Joseph Isaac Feldman - *Telsey Advisory Group LLC - Senior MD, Assistant Director of Research & Senior Research Analyst*

That's great. And I'll also keep it to one and good luck this quarter.

Operator

Moving now to Mike Baker of Davidson.

Michael Allen Baker - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

A couple of related questions. One, you said March was the worst part of the quarter. So can you talk a little bit about April? It sounds like you said the weakness is continuing, but a little bit more detail there. And then related to that, it looks like -- and this is similar to your previous guidance, but the back half is much better in terms of year-over-year changes versus the implied front half. What gives you that confidence? Is it simply just different comparisons? Or why are we expecting a significantly better back half?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure, yes. So we're not going to comment on specific months, but March was the biggest decline in Q1. And as the sales pressure continued as we exited Q1 -- actually, it was a little more pressure than on sales than we expected. If you remember last year, too, as we got into the second quarter, we talked about how we were still doing about a 30% comp in the first few weeks of May. So we are still lapping those stimulus payments that kind of came in starting in March of last year. And so that's what's driving the lion's share of that sales decline.

As you think about the back half of the year, I mean, there's a number of things. We believe as you get to the back half, most of that stimulus impact, a lot of it will have left in terms of a comparison. We also know, as we look to the back half of the year, we do expect product availability and certain products and categories to improve compared to the first part of this year and also if you look at compared to last year, in Q4, there was some notable product shortages in iconic areas that we talked about not getting, that did have an impact on sales.

We also, in Q4, shortened our store hours in January as we were lapping some of the Omicron variant impacts. And then lastly, I comment is we do expect our initiatives to start to continue to drive more impact to our sales outlook as you get further down into the trajectory of those ramps. So those are the reasons I'd highlight.

Operator

Next, we move to Karen Short of Barclays.

Karen Fiona Short - *Barclays Bank PLC, Research Division - Research Analyst*

I actually just wanted to push a little harder and a follow up on the 2025 guide with respect to where you are at today? And obviously, as you were just asked, you did elaborate a little bit on what the second half and why the second half will look better. But maybe a little more color on why you feel confident in the 2025 guide, about [6 3] to [6 8] in light of the fact that, obviously, 2Q will be much weaker than expected. And then just on that same note, are you factoring in a recessionary environment with respect to your guidance for the year and with respect to your 2025 guide?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Yes. So I will start with the fiscal '25 guidance. I'm going to reiterate what Matt said. It is still really early in the long-range guide that we gave. And there are many moving parts and pieces as I outlined in some of the preprepared comments. And so we remain confident in the initiatives and the

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road map that we have put together to deliver that '25 guide. And as Matt said, it's a pretty wide range. So what we're going to use this year to do is to continue to understand how those initiatives develop, how this year plays out, obviously, and then how the implications for all of that in that longer-term guide. But I think if it warrants giving it some time to see how the year is going to play.

Specific to your point about recession, I want to take one step back here for a second. I think I want to start with a reminder that this is a very stable industry. Consumer electronics, over time, is a stable industry. And the last 2 years have clearly underscored the importance of tech in people's lives. So I think it's important for us to have that as a backdrop and the fact that we were obviously already planning for our industry to decline this year, and then we've adjusted based on what we're seeing in the most recent results. It's fair to say that we're factoring in elements of softer demand, but we are not planning for a full recession or guide. We'll not assume a full recession at this point. Obviously, if that were the case, we will continue to update the performance and the expectations. But I think I would characterize our guide more as a softer environment, not a full recession.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

And I might just add, I think also, I think you made a question around the rate guide as well. I think as you think about the rate this year, we're actually not too far off from our original guidance expectations for this year from 5.2 to 5.4, just acknowledging a little bit of softer on the sales side. But all of the structural things that are included in that expectation are kind of coming in as we expect. It's nothing that's too dissimilar at this point. And we have already built those into what we see this year and what we see in the out years to be confident in addition to sales, but also being able to achieve some of those rate expectations for FY '25.

Operator

Seth Basham of Wedbush Securities has our next question.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - MD of Equity Research*

I like to follow up on the promotional environment. If you could give us some [context] as to what you're planning for it in terms of promotions this year relative to pre-pandemic levels? And how much is embedded in terms of gross margin pressure relative to your prior guide, that would be helpful.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes. So I would say it's fair to say we expected, like I said earlier, that promotions return closer and closer to FY '20. Throughout this year, exactly when that happens, we're not commenting on, but we would expect it to increase as the year progresses. Importantly, as you look to the back half of this year, though, we are starting to lap where promotions increased last year, starting in July in computing. So we have baked into our plans a slow increase of promotionality in most categories as you get towards the back half of this year. Exactly where that lands exactly at FY '20, we're -- it's hard to exactly say, but we have baked that into the plans.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

And I think it's worth noting, and I know all of you know that, but just to reiterate, obviously promotions are not just a function of Best Buy, they're a function of relationships with our vendors as well. We're interested in ensuring that their newest and greatest products are out there for the world to see and priced appropriately. So this is not just a function of Best Buy promotionality. It's a function of the overall industry promotionality and partnership with our vendors.

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Operator

We now move to Jonathan Matuszewski of Jefferies.

Jonathan Richard Matuszewski - *Jefferies LLC, Research Division - Equity Analyst*

Matt, a lot of our clients are focused on the ability of companies to flex expenses in an environment of slowing demand potentially persisting. Could you just update us on the fixed and variable split in your P&L and priorities for reduced discretionary spend if the backdrop does worsen?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure. Yes. So as we started the year, we -- even the guide that we gave at 5.4% on a range of sales outcomes, we -- there's a level of implied already trying to understand the levers you do to keep within the 5.4% rate in terms of the original guidance. So it's something that we do as a normal course of business as we see sales slide up or slide down from our expectations. There are a number of areas where you can -- that simply happen because they're variable too like check lane tender, but you also start to adjust areas like marketing or store labor associated with the lower volumes if it does happen. So those are the variable things that we look at to adjust to as the sales trends change.

In addition to that, there are even some more discretionary areas that you can start to look at in addition to variable items. But in some cases -- or even additional marketing to the extent that you're comfortable or even simple areas like travel or adjusting your capital spend, which can adjust depreciation depending on when you do that during a year. So there are variable and then more discretionary. And as Corie noted, we're not really planning for a recession this year to the extent that we did, there's obviously more fixed cost areas you can look at if business trends down even more. Right now, we're not planning for that. You can imagine if that had happened, we would look at some of those areas as well. But we would -- in any event, we're trying to hold dear to us strategic investments that we're making, that provide that long-term growth to get to our FY '25 goals. So that's the last place that we will look at reducing as we look to this year in terms of how we see it now.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

I do think it's fair to say the team has obviously navigated this softening environment quite well up to this point. And obviously, the factors that we use, as we are trying to adjust to that softer demand, obviously overlap with the considerations that you would take into account if you were managing for a recession. So you can imagine behind the scenes, you're running through a bunch of scenarios. And I think the team has done a nice job flexing with a rapidly changing environment and it's that same type of kind of mindset and considerations you would take if that were to flex down even further.

Operator

Next, we move to Brad Thomas of KeyBanc.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

Just want to ask about inventory a bit. Corie, I think you characterize inventory as being overall healthy. But just wondering if you could put that into a little more context, talk about some of the levers you may be able to pull if the consumer continues to weaken here? And then maybe if you could just help us think a little bit more about how much inventory levels were up just because of inflation and ASPs.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Yes. First, just some gratitude to the team who has really done amazing work, carefully managing our inventory levels and then importantly, leveraging some of the investments that we have made in our supply chain. Some context is helpful here. Our inventory balance was unusually

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low last year. So again, if you remember how much demand there was in the marketplace at 37% comp, we had an unusually low balance last year. And that inventory balance right now is almost perfectly in line with the sales growth versus pre-pandemic. So if you went back to kind of normalized prepandemic, now sales growth and inventory growth are almost perfectly in line. And I think that's a true testament to our vendor partnerships and proactively managing those levels in line with what we've been seeing.

Behind the scenes, as you can imagine, actually, units in some of the key categories are down as we've seen ASP shifting from the variety of factors that I noted, whether it's premium and the mix shift in our business or inflation. So that's even what underscores the confidence that I have in the statement around our inventory being healthy, feeling very much like it's in the right place. I think it is important to note, there is still some spotty constraints in very isolated areas for specific vendors and some of the more iconic SKUs that Matt mentioned. But overarchingly, we feel very strongly that we are in a good inventory position, and that's very much in line with how we have managed inventory historically.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

That's great, Corie. And any context on how much inflation has your inventory up?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Yes. We haven't sized it specifically as I kind of alluded to the fact. It's really hard because that said, when we talked about the different pieces that are driving our ASPs up, you've got mix shifts in the business. As people have skewed more premium, you've got more appliances, which tends to skew to higher ASPs. You've got overarchingly, over the last couple of years, fewer markdowns, less promotions, and then you also have inflation. So all of those pieces add into the ASP increases we've been seeing. That's why the color I'm trying to give is we've actually seen in many of the key categories that the unit levels of our inventory are actually down versus some of the pre-pandemic comparisons and a lot of that is being driven by this kind of confluence of ASP increase.

Operator

Scot Ciccarelli from Truist Security has our next question.

Scot Ciccarelli - *Truist Securities, Inc., Research Division - MD*

Scot Ciccarelli. So Corie, we've heard that several other retailers that had a pretty tough March and April have indicated that sales have started to improve in May. But your comments on 2Q would suggest you really haven't seen that. So I guess my question is, why do you think your business hasn't necessarily seen the kind of recovery we've seen in some other retail verticals? And related to that, would your cadence comments be different if we are looking at stock trends?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

I'll start and then Matt can clean up anything that I missed. But you have to also look back to last year, and Matt alluded to this. we have that really high sustained growth into May. Like we posted the 37% comp in Q1, and then that sustained 30s into May. So we were -- we -- unlike some others, we are lapping very sustained high growth, both stimulus related, stay at home related from last year, which is a different cadence. I also think you've heard other retailers comment on the weather and some of the -- and that's not going to impact our business nearly as much as others. So I think from a -- like when we -- you almost have to go back to kind of a 3-year look at the business, it's relatively consistent and actually pretty strong as we're heading into Q2 on that 3-year stack.

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Operator

Moving now to Scott Mushkin of R5 Capital.

Scott Andrew Mushkin - *R5 Capital LLC - Founder, Managing Partner, CEO & Director of Research*

So I want to get back to profitability a little bit. And the question is basically if, and I know it's a big if, sales or revenues would fall back to where they were prepandemic. Do you guys believe the business even with that is structurally more profitable? And if so, why would you believe that?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes, I think we believe that it is structurally more profitable than it was pre-pandemic. As you think about some of the actions and work we've done over the last 2 years to adjust our model with the very heavy shift to digital sales almost doubling from pre-pandemic. We've taken appropriate action to understand the cost structures whether they're to support digital or in our stores or just to support a different type of customer fulfillment need. We've taken the right actions over that period of time to adjust our model -- our cost model to understand -- to account for the changing sales and margin structure -- our gross margin structure. So we fundamentally do believe that -- that's how we actually decide to fulfill product to customers. That's on how many associates we have in our stores.

It's a number of things that we've thoughtfully looked at over the last couple of years to change the structure of cost between gross margin rate and SG&A., so we do believe that fundamentally. In Q1, we were up 80 basis points compared to Q1 pre-pandemic, and that is to account for even though we do have investments like Totaltech at 100 basis points in Q1 and have a doubling of the e-com business, which is a higher parcel cost, we're still getting SG&A leverage considerably better over in Q1 to offset some of those gross margin investments that we're actually making in our business. So we fundamentally do believe that the structure of our business is apparently more profitable. And that's also underlying in our commitment, our goal is to get to that FY '20 goals of 6.3% to 6.8%.

Operator

We move next to Peter Keith of Piper Sandler.

Peter Jacob Keith - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

One area I was hoping you could address was the Best Buy Ads initiative. My understanding was that should be accretive to gross margin. And obviously, there seems to be some change or evolution of the ad spending backdrop. So maybe address any changes to the outlook of that program. And separately, just sticking on gross margin, Matt, should that 100 basis points of Totaltech pressure that you saw in Q1, should that continue with Q2?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure. I'll start with the Totaltech pressure. As you look towards the back half of the year, we start to lap the launch of Totaltech. So we expect the Q2 drivers to be similar to Q1. That would include Totaltech pressure of around 100 basis points. But as you look to Q3 and Q4, we begin to lap it. We launched Totaltech in October of last year, so we don't lap until the end of this Q3. So there's still a little pressure from Totaltech in Q3. Then by Q4, the pressure on a year-over-year basis essentially goes down to 0, if you will, because we've lapped at the launch of it. So that's how the cadence of Totaltech pressure goes.

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Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

And just a quick reminder on the ads business. Obviously, this is us selling advertising to brands that want to reach our customers, both on our own channels and then on some external sites. I think what's important here is that our leadership in CE retail remains very, very valuable, high customer traffic and engagement. And it's that first-party data that we have, which can allow our advertisers to reach really unique audiences. Because we see people all along their purchase journey, which means you can target them at various points in the purchase journey.

We haven't shared specific financial details, but we did see growth in the ads business in Q1, but not material enough to highlight for the quarter, but even entering the year, we knew this would be a favorable contributor to the gross profit rate, but a little bit more weighted towards the second half of the year as this ramp continues. And then obviously, this is something that provides that ongoing growth and incremental profitability over time that gives us confidence in those longer-term targets.

Thank you, Peter. And with that, I want to thank you all for joining us today. I hope that many of our investors who are listening today will be able to join us at our Annual Shareholder Meeting, which will be held virtually on June 9. Thanks, everyone, and have a great day.

Operator

Thank you. Ladies and gentlemen, that will conclude today's conference call. Thank you for your participation. You may now disconnect.

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